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DAIRY AND PRODUCTS ANNUAL

On Sharp Decline

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Report Highlights:

As domestic consumption contracts and export demand weakens, production of dairy products in Ukraine are expected to decrease in 2009-2010. The number of dairy cows is in decline and fluid milk production will not be fully compensated by a modest productivity increase. Russia will remain the prime destination for Ukrainian cheese, but trade will remain limited by sanitary barriers. Exports of Ukraine's dry dairy products collapsed in 2008-09 and are expected to remain low in 2010 mainly due to a shortage of raw milk. In 2009 Ukraine became an importer of butter and dry high quality dairy products for the first time ever. The situation will not change significantly in 2010.

Executive Summary

Ukrainian dairy processors continue to face a fluid raw milk shortage. Together with decreasing demand both inside the country and in export markets this factor is responsible for a significant dairy product production decrease in 2009. The situation in 2010 is expected to be similar: production of fluid raw milk is expected to decline by 2-3% as a result of a decrease in dairy cows. Cows' productivity is expected to grow a bit, similarly to previous years, but the significant cow number cut will undermine milk production growth. The bumper crop 2008 and cheap feed supplies had a limited effect and slowed down decline insignificantly.

A majority of fluid milk continue to be procured by households. The poor quality of raw milk is not allowing industry to compete in world markets where SPS barriers have grown from year to year. Russia tightened its import requirements for Ukrainian cheese, but in 2009 industry managed to keep export flows at high levels. Access to the Russian market is expected to remain limited in forecast years, where Ukrainian cheese traditionally occupies a lower market segment.

As expected, low-margin products like NFDM and WDM became the first victims of a raw milk shortage dragging butter production down as well. Production of high-margin whole milk products and cheese will not offset losses completely due to 8-12% demand drop.

In 2009 Ukraine became a first time ever importer of high quality NFDM and butter. This is the result of 17 years of a cow inventory decrease and the general inefficiency of dairy enterprises in the country. Imports in 2010 are expected to continue.

Production

Ukrainian dairy processors continue to rely on milk procured in private households as a major source of raw fluid milk supply: former collective agricultural enterprises (industrial farms) are responsible for only 18% of procured milk. This leads to significant quality problems since most households practice hand milking and lack proper chilling equipment. Milk from private households can hardly be used for cheese production or for many whole milk dairy products due to bacterial presence. Household milk production is more immune to sharp market fluctuations and price drops. Villagers produce milk for their families, and leftover amounts are sold to processing companies. Milk sourced from industrial farms remains the number one choice for dairy processors despite some similar quality problems.

In order to address the fluid milk quality problem the Government of Ukraine (GOU) introduced a draft of the new Technical Reglament "On Raw Fluid Milk's Quality and Safety Assurance" in early June of 2009. The proposed regulation envisaged significantly stricter requirements for raw milk and would prevail over existing State Standard DSTU 3662-97. The Reglament would establish microorganism tolerance levels compatible with EU norms. The maximum temperature of procured milk would be +6°C. The dairy industry viewed the proposed Reglament as an awkward attempt to stabilize the dairy market. The quality of Ukrainian raw milk is a consequence of production practices in households rather

than a lack of proper technical regulations. According to some experts only 30% of Ukrainian fluid milk would fit into new Technical Reglament norms. There is no way for the industry to contract milk procurement by 70%. If adopted, the document is not going to be followed by Ukrainian processors.

The world financial crisis placed another strain on the development of Ukrainian dairy industry. Inspired by growing domestic demand many processors relied heavily on bank loans in their expansion programs. Many received USD denominated bank loans for equipment purchases and restructuring. After the devaluation of Ukrainian currency (from 4.65 UAH/USD in July of 2008 to 8.10 UAH/USD in October of 2009) processors found themselves in the situation where sales of dairy products are fixed in UAH, while liabilities are fixed in USD. Many filed for debt restructuring, a few were bankrupted and some had to accept hostile takeovers from not so unfortunate competitors.

On the internal policy side Ukraine made another attempt to strengthen internal sanitary requirements for dairy products produced in households. These new requirements in Paragraphs 33 and 35 of the Law On Safety and Quality of Food Products and Raw Materials would become effective on January 1st 2010. Sales on open-air markets of fluid milk and soft cheese produced in households would be banned. If implemented, the requirements would reshape the domestic dairy market significantly since a significant share of milk from households is sold through open-air markets. Since it is unclear whether these regulations would come into power as scheduled, there is a good chance that they will be postponed until 2015. Strong opposition against the new rules came from small business, regional state administrations and rural municipalities.

For the 2009/10 season, production of raw milk is expected to decline by 2% despite quite a significant cow inventory decrease (please refer to Table 1 below). A shortage of quality raw milk together with relatively low world market prices negatively impacts production of all dairy products. Production of dairy products for domestic consumption is also expected to decline in 2009. Production of fluid pasteurized packed milk is expected to contract by 5%, dry milk products by 36%, butter by 15%, soft cheese by 8% and sour milk products by 8%. The only two items which may show some growth are cheap melted cheese (+5%) and low-priced yogurts (unflavored, no fruits or nuts added)(+40%).

The situation for 2010 is not clear due to macroeconomic developments that are beyond the scope of this report. The Ukrainian currency devaluation, continued real income drop, banking sector developments, world market situation as well as political developments in neighboring Russia – all these factors may impact Ukrainian dairy production in 2010. Production of products destined for the domestic market is likely to stabilize around 2009 numbers. Production of cheese, yogurts and other whole milk products is expected to be relatively stable as demand stabilizes at a new post-crisis level. Production of dry milk products is expected to remain low due to raw milk shortage as well in response to low world market prices.

Table1. Production Indicators for Farms of all Types**Jan 1st – Sep. 1st (1000 Heads)**

Farm type	2008	2009	2009 % to 2008
Farms of all types			
Number of cattle	5746.1	5538.9	96.4
- including dairy cows	3022.9	2850.4	94.3
Industrial Farms			
Number of cattle	1817.5	1695.1	93.3
- including dairy cows	651.0	617.8	94.9
Households			
Number of cattle	3928.6	3843.8	97.8
- including dairy cows	2371.9	2232.6	94.1

Source: State Statistic Committee of Ukraine

Prices for raw milk fluctuated significantly in 2009 and are expected to remain relatively high in 2010 despite constantly low quality. Processors have no choice but to compete with each other from the available supply. Even during the summer of 2009, prices for household products fluctuated between 1.0 –1.3 UAH/liter (12.5 cents/liter) and 1.5-2.2 UAH/liter (19-28 cents/liter) for industrial farms. Although UAH denominated prices look similar to last year's prices, in USD they decreased 40-60%.

Consumption

Overall consumption of dairy products (both produced in households and industrially) decreased in 2009 by 8-12%. Consumption of staple dairy products (butter and hard cheese) remained close to 2008 numbers, while consumption of whole dairy products decreased by 20 -30%. Industry experts notice a significant shift in consumer preferences toward cheaper soft and hard cheeses, yogurts and home-made sour-milk products. The situation in the dairy industry was especially bad in January-February of 2009, when many processors stopped production completely.

Decreased demand from industrial consumers (both inside the country and on the world market) had a devastating effect on production of NFDM and WDM. Consumption of these products contracted the most. Dairy processors, which observed trends for increased consumption of high value-added products in 2003-08 and changed their assortment accordingly suffered the biggest losses in 2008-09. The demand for cheaper products is expected to continue throughout the rest of 2009 – 2010 and some market players may not survive the crisis.

Cheese

Despite a raw fluid milk shortage and somewhat weakened demand in the domestic market, production of cheese in 2009 is expected to be close to the 2008 number. Given stable, or somewhat decreased demand domestically, production of cheese is tied to import demand from the major importer – the Russian Federation. Despite trade barriers Ukrainian cheese makers continues to supply their produces to Russia in 2009 while Russia regulates supply by listing or delisting Ukrainian producers. It is unknown if Russia

will continue to audit Ukrainian dairy facilities. Ukrainian cheese producers complained that Russian inspections were conducted without clearly defined criteria and lacked transparency. (Current PS&D forecast is based only on currently existing exporters.)

Ukraine's competitors in Russian markets face similar limitations: unpredictable facility inspection and sporadic import requirements changes. Crisis developments in Russia also somewhat benefited Ukrainian producers which occupied lower market segments where consumer preferences shifted. The position of Ukrainian cheese in Russia may strengthen in 2009 even more as Russia introduced an additional 15% import duty on hard cheese. This increase will not affect Ukrainian exports as they enjoy the FTA trade regime. Production capacities of Ukrainian cheese makers will easily allow 30%-40% export increase, should this be demanded by the Russian market and allowed by Russian inspectors. Export will continue to be attractive despite growing problems with value-added tax (VAT) export refunds. Facing a significant budget deficit, the GOU delays or postpones for long periods, their VAT export compensations to Ukrainian dairy exporters.

Similar to butter, domestic consumption of cheese remained inelastic and the real income drop of 2008-09 did not change it much. In 2010 production of cheese is not expected to change significantly mostly due to a lack of markets where low-end cheese can be sold. Shortage of milk will not impact production significantly since cheese is a relatively high value-added product with good growth potential in upper market segments.

Production of cheese throughout the crisis period resulted in growing shares for cheaper products and some shift of consumer preferences toward soft and melted cheese. These market segments grew by 7-10% for the first time in the last 5 years. Production costs for typical hard cheeses with 45% fat content in last 5 years almost doubled from 15 UAH per kilogram (\$2.8 /kg) to 27 UAH per kilogram (\$3.3 /kg). Most of the cost increase comes from higher raw fluid milk price. Many Ukrainian producers started to use vegetable oils in an attempt to decrease the production cost. This technology change negatively influenced the quality of the final product. Besides, producers preferred to keep this secret and did not label the product properly. When the crisis weakens the production in Ukraine will get more structured and cheese is expected to be branded by type, not by producer. Small cheese makers, not able to invest additional money in business will have to leave the market or will be acquired by bigger companies. Although consumption of hard cheese is relatively stable, in the future it may grow.

Butter

Production of butter in Ukraine will contract in 2009 significantly, continuing a 3 years long trend downward. Facing competition for expensive raw milk from high-margin whole dairy products and cheese, Ukrainian butter producers found themselves in a situation when profitable production is impossible.

The domestic consumption of butter is inelastic and is not expected to change much despite possible modest price fluctuations. The quality of Ukrainian butter was a problem even before the financial crisis and the world market price decrease. Use of plant oils and some dairy byproducts in butter production

without proper labeling brought a bad reputation to Ukrainian producers. The butter segment was the first to disappear from Russia despite positioning of Ukrainian product in the low-end market segment. Strict requirements for the product from Russian controlling agency undermined Ukraine's position. New Ukrainian butter standards came into power in late 2008. This new regulation made producers clearly identify spreads on the packaging.

Production of butter is highly dependent on profitability of butter + NFDM combination. Given extremely low NFDM prices through 2009, the production of butter remains unattractive.

In 2009 Ukraine became a first time ever importer of butter. The overwhelming majority of the product arrived from neighboring Belorussia. Heavy subsidies of the planned economy stimulated Belorussian producers to make use of the existing FTA with Ukraine, and export expansion started. The veterinary requirements of both Belorussia and Ukraine are a legacy of soviet veterinary control systems and differ insignificantly. The Ukrainian veterinary service conducted inspections and found no problems with the safety of Belorussian product. The quality of imported product is by far superior to Ukrainian butter.

Supplies to Ukraine came very handy for Belorussian dairy producers due to tightened control and trade restriction introduced by the Russian Federation against Belorussia. Initial attempts to supply Belorussian butter to Ukraine were made well before the financial crisis and world dairy products price collapse.

NFDM / WDM

Production of dry milk in Ukraine is a function of highly seasonable raw milk production and the industry's strong dependence on availability of this seasonal milk. Dry products have the lowest margin in comparison to other dairy products, face very small domestic market and suffer the most should price problem or raw fluid milk supply problem arise. In the 2008-09 season both these problems are evident: in the middle of 2008 the price for NFDM in Ukraine collapsed from \$2800 to almost \$1600 rendering production of NFDM and butter obsolete. A 40% price drop for NFDM and 36% drop for WDM leads to a 36% combined dry milk production decrease in 2009.

Ukrainian producers quickly switched to high-margin cheese and whole dairy products. The export of NFDM and WDM from Ukraine decreased significantly. A significant chunk of the domestic butter market was abandoned and left to Belorussian exporters. Not surprisingly, butter production contraction led to accompanied NFDM shortage. Limited supplies of Byelorussian NFDM started in 2009 to compensate for lack of domestically produced product. Belorussian producers happened to be competitive even at existing extremely low price levels. Similarly to butter, the quality of the product is superior to Ukrainian dry milk. The veterinary control systems of two countries are also very similar.

The Ukrainian statistics service provides only 1 number for dry dairy products (NFDM, WDM and dry whey). Data in the PS&D for NFDM and WDM were obtained from consulting with companies, industry representatives and FAS/Kyiv market research.

A general production and export forecast for 2010 is negative due to a number of factors. Raw milk shortage and low prices for dairy products both domestically and in the world market give little hope for production increases. Domestic consumption is relatively stable and not expected to change much in 2010. Due to crisis developments many countries' consumption of high value added dairy products contracted, thereby contracting dry milk consumption. Access to loans due to world financial market unrest will also negatively impact consumption and export.

Production of NFDM is likely to be less profitable than WDM due to the production of butter, which had no market outside of Ukraine. Both NFDM and WDM remain relatively low-margin products and long term production forecasts for these in Ukraine is negative. Facing a significant shortage of raw fluid milk, producers would prefer to utilize it in a more profitable manner.

Statistical Tables

Fluid Milk PSD Table*

Dairy, Milk, Fluid Ukraine	2008			2009		2010
	Market Year Begin: Jan 2008			Market Year Begin: Jan 2009		Market Year Begin: Jan 2010
	Annual Data Displayed		New Post Data	Annual Data Displayed	New Post Data	New Post Data
Cows In Milk	2,979	2,979	3,096	2,770	2,856	2,730
Cows Milk Production	11,070	11,070	11,524	10,350	11,300	10,961
Other Milk Production	280	280	238	280	240	240
Total Production	11,350	11,350	11,762	10,630	11,540	11,201
Other Imports	2	2	1	1	1	1
Total Imports	0	0	0	0	0	0
Total Supply	11,352	11,352	11,763	10,631	11,541	11,202
Other Exports	0	0	0	0	0	0
Total Exports	13	13	16	2	14	12
Fluid Use Dom. Consum.	2,779	2,779	3,520	2,109	3,527	3,120
Factory Use Consum.	7,400	7,400	7,197	7,450	7,050	7,150
Feed Use Dom. Consum.	1,160	1,160	1,030	1,070	950	920
Total Dom. Consumption	11,339	11,339	11,747	10,629	11,527	11,190
Total Distribution	11,352	11,352	11,763	10,631	11,541	11,202
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0
TS=TD			0		0	0

**These are not official USDA numbers*

Cheese PSD Table*

Dairy, Cheese, Ukraine	2008			2009		2010
	Market Year Begin: Jan 2008			Market Year Begin: Jan 2009		Market Year Begin: Jan 2010
	Annual Data Displayed		New Post Data	Annual Data Displayed	New Post Data	New Post Data
Beginning Stocks	0	0	0	0	0	0
Production	256	256	249	260	250	245
Other Imports	13	13	13	11	9	10
Total Imports	13	13	13	11	9	10
Total Supply	269	269	262	271	259	255
Other Exports	78	78	77	70	77	75
Total Exports	78	78	77	70	77	75
Human Dom. Consumpt.	191	191	185	201	186	195
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	191	191	185	201	182	180
Total Use	269	269	262	271	259	255
Ending Stocks	0	0	0	0	0	0
Total Distribution	269	269	262	271	259	255
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0
TS=TD			0		0	0

*These are not official USDA numbers

Butter PSD Table*

Dairy, Butter, Ukraine	2008			2009		2010
	Market Year Begin: Jan 2008			Market Year Begin: Jan 2009		Market Year Begin: Jan 2010
	Annual Data Displayed		New Post Data	Annual Data Displayed	New Post Data	New Post Data
Beginning Stocks	0	0	0	0	0	0
Production	89	89	85	88	72	70
Other Imports	0	0	3	0	18	20
Total Imports	0	0	3	0	18	20
Total Supply	89	89	88	88	90	90
Other Exports	7	7	6	7	1	0
Total Exports	7	7	6	7	1	0
Domestic Consumption	82	82	82	81	89	90
Total Use	89	89	88	88	90	90
Ending Stocks	0	0	0	0	0	0
Total Distribution	89	89	88	88	90	90
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0
TS=TD			0		0	0

*These are not official USDA numbers

Nonfat Dry Milk PSD Table*

Dairy, NFDM, Ukraine	2008			2009		2010
	Market Year Begin: Jan 2008			Market Year Begin: Jan 2009		Market Year Begin: Jan 2010
	Annual Data Displayed		New Post Data	Annual Data Displayed	New Post Data	New Post Data
Beginning Stocks	2	2	2	2	2	2
Production	65	65	65	58	48	50
Other Imports	0	0	0	0	9	10
Total Imports	0	0	0	0	9	10
Total Supply	67	67	67	60	59	62
Other Exports	40	40	44	30	23	25
Total Exports	40	40	44	30	23	25
Human Dom. Consumption	25	25	21	28	34	35
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	25	25	21	28	34	35
Total Use	65	65	65	58	57	60
Ending Stocks	2	2	2	2	2	2
Total Distribution	67	67	67	60	59	62
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0
TS=TD			0		0	0

*These are not official USDA numbers

Dry Whole Milk Powder PSD Table*

Dairy, WDM, Ukraine	2007			2008		2009
	Market Year Begin: Jan 2007			Market Year Begin: Jan 2008		Market Year Begin: Jan 2009
	Annual Data Displayed		New Post Data	Annual Data Displayed	New Post Data	New Post Data
Beginning Stocks	0	0	0	0	0	0
Production	40	24	30	37	15	14
Other Imports	0	0	0	0	1	1
Total Imports	0	0	0	0	1	1
Total Supply	40	24	30	37	16	15
Other Exports	23	11	21	19	4	5
Total Exports	23	11	21	19	4	5
Human Dom. Consumpt.	17	13	9	18	12	10
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	17	13	9	18	12	10
Total Use	40	24	30	37	16	15
Ending Stocks	0	0	0	0	0	0
Total Distribution	40	24	30	37	16	15
CY Imp. from U.S.	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0
TS=TD			0		0	0

*These are not official USDA numbers